United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-1157

To be argued by
STUART D. WECHSLER

In The

United States Court of Appeals

For The Second Circuit

WILLIAM R. VAN GEMERT, ALBERT A. HENNING, EDWARD E. HOUCHINS, NATHAN PEARLMAN, ELIAS A. CHARIOTT, CHARLES K. DAVIS, ANDREAL HOLDING CORP., SAMUEL A. WEISS, IRWIN L. ISERT, JACK KIRSCHNER, CHARLES FRIEDMAN, H. MICHAEL ALBERS, ABRAHAM STERN, EDWARD KEMPLER, SIMEON A. SCHLOSS, JR., MARY JANE SCHLOSS SILVERMAN, SIMEON A. SCHLOSS, JR., and MARY JANE SILVERMAN, Trustees under the Last Will and Testament of Floretta Schloss Wile, DAVID M. BOTSFORD, MRS. SAMUEL LEMLER, LOUIS DAVIS, MRS. LEONARD C. DILL, JR., JOSEPH SCHLAGMAN, NATALIE K. WIGLER, ANN LOUISE DIAMOND, SAMUEL CHARDAVOYNE, WILLIAM M. JONES, MR. & MRS. H. DIENEMAN, MILTON HART, MARY LEVIN, FRANCES DAVIS, E. JULIAN DAVIS, ROBERT LEMLICH, ARTHUR FRISCH, MARIAN S. MITCHELL, VINCENTE J. BONNARD, HAROLD M. WHITE and MARGARET C. WHITE, MORRIS BERNSTEIN, WALTER

(Continued)

On Appeal from Judgment of the United States District Court for the Southern District of New York.

BRIEF FOR PLAINTIFFS-APPELLANTS

L. EATON, ERNEST G. ANGEVINE, ABRAHAM PERCHICK, COMMITTEE FOR THE ESTATE OF MAX SCHNEIDER, an incompetent, FRANCIS H. SHOOBE, and ALBERT A. ARDITTI, GERTRUDE McNAUGHT, MRS. J. H. STEIN, JOAN S. BERMAN, J. DAVID STEIN, SARAH E. MORITZ, VIRGINIA W. STAUB, LOUIS BERGLAS, DR. JACK DIENER, DENNIS J. FINN, BERTHA J. WINER, JOANNE W. FINN and S. EDWARD MITTLER, for and in behalf of themselves and for all other holders of the BOEING COMPANY 4-½% Convertible Subordinated Debentures, due July 1, 1980 who are similarly situated,

Plaintiffs-Appellants,

vs.

THE BOEING COMPANY (formerly BOEING AIRPLANE COMPANY), CLAIRMONT L. EGTVEDT, WILLIAM M. ALLEN, EDWARD C. WELLS, JAMES E. PRINCE, LOWELL P. MICKELWAIT, W.L. CAMPBELL, ARTEMUS L. GATES, CRAWFORD H. GREENEWALT, WILLIAM G. REED, D.E. SKINNER, THOMAS R. WILCOX, JOHN O. YEASTING and GEORGE H. WEYERHAEUSER,

Defendants-Appellees.

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-against-	:	Docket No. 74-1157, etc.
THE BOEING COMPANY, et al., Defendant-Respondent.	:	

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APPELLANTS' REPLY BRIEF

REPLY POINT I

There Is No Merit To Appellees' Contention That Boeing Is Not Liable Because It Violated A Provision Of The Stock Exchange Manual, Rather Than A "Rule", And Because It Is A Listed Company Rather Than A Member.

The appellees contend that violations of the Stock Exchange Manual are not actionable, although violations of Exchange Rules specifically denominated as "rules" would be actionable, and that violations of rules by listed companies, as opposed to members, are not actionable. In support of the contention that violations of the manual are not actionable, appellees claim that the manual is suggestive and not mandatory. In support of the contention that Exchange rule violations by listed companies are not actionable, the appellees rely upon their interpretation of a 10-year old case, O'Neill v. Maytag, 339 F. 2d 764 (2d Cir., 1964), and legislative history. How-

ever, the provisions of the Exchange Manual violated by Boeing are demonstrably mandatory and not merely suggestive, the O'Neill case has been interpreted entirely differently by Judge Friendly in the landmark case of Colonial Realty Corp. v. Bache & Co., 358 F. 2d 178 (2d Cir., 1966), cert. denied 385 U.S. 817, and the legislative history cited by the appellees is completely inapplicable to their contention.

A. The Provisions of Section A 10 Violated By Boeing Are Mandatory and Not Merely Suggestive.

To a large extent, appellees' contention that Section A 10 is to be treated differently than Exchange Rules denominated as "rules" has already been controverted on pages 28-31 of appellants' main brief. Rather than repeating those pages here, the court is respectfully referred thereto. What follows is a rebuttal only to the extent not already covered.

The contention that the publicity requirements of Section A 10, violated by Boeing, are merely suggestive is belied by a brief examination of the section itself. Other provisions of Section A 10 are expressly stated to be suggestive, whereas the publicity provisions violated by Boeing are, in contradistinction, stated in mandatory form. For example, Section A 10 contains a provision that the general release "should" be released to one or more newspapers of general circulation in New York City which regularly publish financial news . . . ", but mandatory language that "such news release shall be made as soon as possible after corporate action which will lead to, or which

looks toward, redemption . . . and <u>shall</u> be made by the fastest available means, i.e., telephone, telegraph or hand delivery," is utilized in setting forth the provisions violated. Thus, the violated portions of Section A 10 can hardly be deemed to be suggestive when suggestions are expressly labled as such in the Section but the violated provisions are described in mandatory form.

The introduction to the Manual itself shows that its contents are not merely suggestive or a guide. The introduction reads:

> "[This Manual] includes a codification of the policies, <u>requirements</u>, procedures and practices of the Exchange relating to listed companies and their securities." (emphasis added)

Clearly "requirements" are not merely suggestive but are synonomous with "rules" and are "instruments corresponding thereto" within the meaning "Rules of the Exchange" as defined in §6(a)(3) of the Securities Act of 1934. See appellants' main brief p. 30.

Not only does Section A 10 itself and the introduction to the Manual show that the violated publicity requirements therein are mandatory, but none of the authorities relied upon by the appellees indicate the contrary.

The appellees state that the Exchange Manual is described as a "handbook" which "outlines good corporate practice" in Vol. 1 of the three-volume CCH Reporter entitled "New York Stock Exchange

Guide". From this description, appellees claim, it can be inferred that the matters in the Manual are suggestive. However, the portion of the description quoted by the appellees is completely out of context since the remainder thereof states that the Manual also contains Exchange policy in matters such as, inter alia, redemptions and disclosure requirements. Thus, a proper quotation of the description is:

> "[The Manual] outlines good corporate practice as well as Exchange policy in matters such as . . . redemptions, . . . disclosure requirements . . .". (1 N.Y. Stock Exchange Guide at 937) (emphasis added)

It is therefore clear that the description states that some provisions of the Manual are outlines of good corporate practice but that others, such as the mandatory publicity requirements violated by Boeing, constitute Exchange policy on required matters. Moreover, any statement in the unofficial CCH Reporter to the contrary must bow to the statement by the Exchange itself, in the introduction to the Manual, that the Manual contains requirements of the Exchange.

The appellees set forth a statement contained in Chris-Craft Industries, Inc. v. Bangor Punta Corp., 426 F. 2d 569, 576 (2d Cir., 1970) to the effect that, although policies of the New York Stock Exchange are entitled to considerable respect, they cannot bind the commission or the courts. However, in that case, the plaintiff sought an interpretation of a Stock Exchange Rule which would compel an exchange offer to be made

before the filing of a registration statement in violation of the Securities Act of 1933. Thus, the court simply held that, to the extent an Exchange rule is in conflict with the Act, the Act is binding upon the court and not the Exchange rule. In the instant action, there is no conflict between Section A 10 and any of the Securities Acts and, therefore, the Chris-Craft case is inapplicable.

The appellees cite DeRenzis v. Levy, 297 F. Supp. 998 (S.D.N.Y. 1969), for the proposition that locus in a book, typography and locality, with respect to a directive specifically designated as an Exchange "rule", is important in determining whether or not a violation is actionable as an Exchange rule, and that only matters known as "rules" or something closely approximating "rules" are actionable. DeRenzis, however, had nothing to do with the issue as to whether or not a directive in an entirely different volume from the general rules constitutes an actionable rule of the Exchange, but dealt only with matters designated as "Supplementary Material" located under specifically designated rules. In DeRenzis, the plaintiff sought to impose liability for violations of "Supplementary Material" set forth under a specifically designated Stock Exchange Rule, i.e., Rule 440. When the court noted the importance of typography, locality and designation of a directive as a "rule", it was simply recognizing the fact that Supplementary Material under a rule does not constitute the rule itself and, therefore, may

not be actionable. However, in the instant action, a violation of Supplementary Material under a rule is not at issue, but at issue is a violation of an expressed requirement of the Exchange which is stated in mandatory form and completely independent from any directive more specifically denominated as a "rule".

The appellees also claim that there is nothing in the listing agreement which incorporates the Manual by reference or refers to it in any way. This is an absurd contention in view of the fact that the section of the Manual violated expressly refers to the listing agreement, i.e., it states "the company's listing agreement with the Exchange requires immediate publicity . . . " and the "term 'publicity', as used in the foregoing paragraph and below, and as used in the listing agreement . . . refers to a general news release . . . ". (E 43, P. a 170). Thus, Section A 10 of the Manual clearly defines the meaning of the term "publish" as used in Sec. III, par. 4 of the listing agreement, by virtually conclusive parole evidence as to the meaning of such term. Hence, violations of the publicity provisions of Section A 10 of the Manual are necessarily violations of the listing agreement.

The appellees also quote from the introduction of the Manual which states that certain exigencies may require deviation from even the most explicitly stated policy or requirement. However, the word "requirement" as utilized in that portion of the introduction is certainly broad enough to include directives

specifically denominated as "rules" and, therefore, provides no basis for a distinction between such directives and directives set forth in the Manual.

Appellees also cite a statement by Mr. Phillip L. West, a former vice-president of the Exchange, made at a P.L.I. discussion, where he referred to "these guidelines" contained in the Manual. However, Mr. West was referring only to the suggestive provisions in the Manual and not to the mandatory provisions therein such as the publicity provisions of Section A 10 violated by Boeing.

Finally, the appellees refer to the Report of Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88 Cong. 1st Sess, Pt. 4, Ch. XII at 566, 567 wherein it is pointed out that a violator of the disclosure provisions of the Manual may be de-listed. However, the fact that the special study points out that the violation by Boeing could be a cause for its de-listing, merely points out the seriousness of the provision and that it is an instrument corresponding to a rule within the meaning of "Rules of the Exchange" as defined in Sec. 6(a)(3) of the Act.

B. The Appellees' Interpretation of the O'Neill case is Contrary to Judge Friendly's Interpretation Thereof in Colonial, and the Legislative History Cited by the Appellees Is Not Applicable.

On pages 50-53 of the appellants' main brief, it is shown that there is no valid distinction between a listed company

and a member company with respect to violations of Stock Exchange Rules. Again, the court is respectfully referred thereto in lieu of unnecessary repetition here.

Appellees argue that O'Neill v. Maytag, 339 F. 2d 164 (2d Cir., 1964), held that listed companies are not liable for violations of Exchange Rules. However, as shown on pages 51-52 of appellants' main brief, in Colonial Realty Corp. v. Bache & Co., supra, the court, speaking through Judge Friendly, interpreted O'Neill as holding only that not all Stock Exchange Rules are actionable. To ascribe to O'Neill a holding that listed companies should be excused for their violations of rules while member companies are not, would be entirely inconsistent with the rationale of the Colonial case and, at best, a retrogression of the law to a time before its development by the modern cases.

In contending that Colonial Realty did not interpret O'Neill as stated above, appellees refer to legislative history. Appellees claim that, in 1934, when the Act was before Congress, a provision "extending coverage of the rules and regulations expected to be adopted under the aegis of the 1934 Act to issuers" was deleted thereby indicating that there should be no civil liability against listed companies. Firstly, however, the provision was to require listed companies to agree with the Exchange to comply with the Act, and much of the discussion centered about whether or not the provision was necessary at all since such companies would have to comply with the law regardless of whether they agree to. As Senator Hastings said on the Senate floor:

> "I do not quite understand why they want to get the issuer of the security on record, in the form of an agreement, not to violate a particular law, because it must be admitted that, if the law itself is valid, and if the rules and regulations made by the commission are valid, and the person entering into the agreement has brought himself within the law by offering his securities for sale, then certainly, it seems to me, the point of compelling him to sign a paper that he will abide by the laws and rules made by the commission must have back of it something which those of us who studied the bill do not quite understand." (78 Cong. Rec. 8585, 1934)

Thus, there is no legislative intent indicated that listed companies were to be exempt from liability by the dropping of the provision, merely a recognition that the provision was unnecessary because they <u>are</u> liable.

Assuming, <u>arguendo</u>, that the deletion of the provision did indicate legislative intent to exclude listed companies from liability, it indicated an intent to exclude them from liability for <u>all</u> securities violations, not just violations of Exchange rules, because the provision was not limited to compliance with Exchange rules. Therefore, such intent provides no reason for treating violations by listed companies of Exchange rules promulgated under the Act differently than their violations of S.E.C rules promulgated under the Act. Since courts have ignored any such legislative history with respect to civil liability against listed companies violating the Act and rules and regulations thereunder, e.g., 10(b)(5) actions, there is no reason for such legislative history to be any more compelling with respect to Exchange rule violations.

REPLY POINT II

Appellees Fail To Show That The Exchange Rule Violated By Boeing Is Actionable Only Upon A Showing Of Fraud.

Appellees contend that the court below was correct in holding that a showing of fraud is required in order to hold Boeing liable for its violation of the Stock Exchange Rules pertaining to publicity requirements. However, not only are the appellees and the lower court erroneous for the reasons stated on pages 34-42 of appellants' main brief, but also because the rule violated in the instant action is a specific rule in accordance with the regulatory scheme of the Securities Acts for assuring adequate disclosure, rather than a vague rule pertaining generally to standards of conduct which can only be part of the regulatory scheme for preventing fraud.

The regulatory scheme of the Securities Acts comprises two distinct means of protecting investors, to wit: (1) by proscribing activities which are tantamount to fraud (e.g., Sec. 10(b) of the Securities Exchange Act of 1934 and S.E.C. Rule 10(b)-5 promulgated thereunder) and (2) by requiring adequate disclosure without regard to fraud (e.g., Sec. 14(a) of the Securities Exchange Act of 1934 and S.E.C. Rule 14(a)-9 promulgated thereunder, and Sec. 11 of the Securities Act of 1933 and the rules and regulations promulgated thereunder). Unlike the provisions designed primarily to prevent fraud, the provisions

of the Securities Acts, and the S.E.C. rules and regulations promulgated thereunder, designed primarily to require adequate disclosure are actionable, per se, without a showing of fraud. Gerstle v. Gamble-Skogmo, Inc., CCH Fed. Sec. L. Rep. ¶93,983 at P 93,940-1 (2nd Cir., 1973); Fischman v. Raytheon Manufacturing Co., 188 F. 2d 783, 786 (2d Cir., 1951).

Many Exchange and N.A.S.D. rules are vague, broad rules, pertaining generally to standards of conduct and having nothing to do with disclosure, e.g., N.Y.S.E. Rule 405 ("know your customer") and the "suitability rule" contained in Art. III, ¶2 of the N.A.S.D. Rules. Since the only standard of conduct proscribed by the Securities Acts is "fraudulent" conduct, these vague rules can be part of the regulatory scheme of the Securities Acts only to the extent that they proscribe "fraud" within the meaning of the Acts and hence may require a showing of fraud to be actionable. Hecht v. Harris, Upham & Co., 283 F. Supp. 417, CCH Fed. Sec. L. Rep. ¶92,139 at p. 96,635 (N.D. Cal 1968), modified on other grounds, 430 F. 2d 1202 (9th Cir. 1970).

Other Exchange rules, however, such as the publicity rule violated by Boeing herein, are specific and designed primarily to implement the regulatory scheme of the disclosure provisions of the Acts and have little if anything to do with the antifraud provisions. Such disclosure rules are part of

the regulatory scheme of the Acts for providing adequate disclosure and, hence, actionable regardless of fraud.

None of the cases cited by the appellees, for the proposition that fraud is required for liability upon Exchange rule violations involve specific disclosure rules as does the instant action, but they involve the type of rule which is vague, aimed at general standards of conduct, has nothing to do with disclosure and, thus, is part of the regulatory scheme only to the extent that it implements the antifraud provisions of the Acts. Since the rule violated by Boeing in the instant action is a specific rule promulgated as part of the disclosure scheme of the Securities Acts, none of the appellees cases are applicable.

For example, in Hecht vs. Harris, Upham & Co., supra, a case heavily relied upon by appellees, fraud was required only because the rule violated therein was aimed at a general standard of behavior, had nothing to do with disclosure, and, thus, was part of the regulatory scheme of the Securities Acts only to the extent that it prohibited fraud. In Hecht, the defendant had violated the "suitability rule" of Art. III, ¶2 of the rules of N.A.S.D., which requires brokers to have reasonable grounds for believing that a transaction is suitable for the customer before recommending same. The court noted that the rule implemented the antifraud provisions of the Acts, to the extent it was part of the

statutory scheme at all, rather than the disclosure provisions where fraud is not an element, by stating:

> "On this point we merely note that the Security Acts, as applicable to this case, are essentially directed at fraud - not against mere negligence or errors of judgment on the part of the broker." (Ibid. CCH at p. 96,634) (emphasis added)

The court then stated the portion of its opinion quoted by the appellees, to wit: that association or Exchange rules which are designed to prevent "unethical behavior", such as the "suitability rule" in question, are not actionable unless the violation is a fraud within the meaning of the provision of the Act pursuant to which the rule is promulgated. The court did not state, however, as appellees would have us believe, that rules which are not designed merely to prevent unethical behavior, but are designed to implement the provisions of the Securities Acts requiring adequate disclosure, also require a showing of fraud to be actionable.

The court in Hecht also explained the wisdom of requiring fraud for finding liability under vague rules such as the "suitability rule" before it, as follows:

> "the question arises whether [the 'suitability rule'] is the kind of rule upon which a civil action for damages by the customer can be based. Conceivably, a broker might honestly think that his 'ground' for believing his recommendation 'suitable' is 'reasonable', only to find himself overruled in a law suit and found guilty of fraud notwithstanding his good faith. As pointed out by Friendly, J., in Colonial, supra, p. 182, the practical consequences of allowing private federal damage suits based on rules of this kind, involving judicial review of market judgments, would be considerable." (Ibid. CCH at p. 96,635) (emphasis added)

In the instant action, where a specific and well defined rule is involved, a rule that simply required Boeing to immediately issue a general news release, no "judgments" are involved and a defendant cannot honestly believe that it is in compliance with the rule when it is not.

Two of the cases cited and quoted from by appellees, Rich v. New York Stock Exchange, CCH Fed. Sec. L. Rep. ¶94,736 (S.D.N.Y. 1974), and Schonholtz v. American Stock Exchange, CCH Fed. Sec. L. Rep. ¶94,539 (S.D.N.Y. 1974), were not decided upon the issue of whether Exchange Rules are actionable, but upon the grounds that the rules involved were not actually violated. Thus, the portions of the opinions from those cases quoted by the appellees, which pertain to liability for violations of Exchange Rules, are clearly dicta. Moreover, in such dicta, both courts said nothing more than that their research had revealed no decisions in which liability for violations of Exchange rules had been upheld without allegations of fraud. Since the decisions prior to those cases involved rules having nothing to do with disclosure, but rules promulgated to obtain general standards of conduct, the results of the courts' research is not surprising. Neither court stated, however, that fraud would be required for liability for violations of all rules, including specific rules designed to implement the disclosure provisions of the Securities Acts.

If fraud is required for liability in some of the cases cited in appellants' main brief, it is only because the Exchange

Rules involved therein also had nothing to do with disclosure but with standards of conduct. However, since the rule violated by Boeing in the instant action is designed to provide adequate disclosure in accordance with the disclosure scheme of the Acts, the presence or non-presence of fraud herein is irrelevant. Moreover, in Starkman v. Seroussi, CCH Fed. Sec. L. Rep. ¶94,600 (S.D.N.Y. 1974), the court stated that fraud might be argued with respect to the registered representative, but previously in its opinion held that a valid cause of action had also been stated against the broker for its violation of the Exchange rules because "The rules here allegedly violated may be considered 'an integral part in S.E.C. regulation'", with no mention of possible fraud by or attributable to the broker. Similarly, in S.E.C. v. First Securities Co. of Chicago, 463 F. 2d 981, CCH Fed. Sec. L. Rep. ¶93,430 (7th Cir. 1972) it was specifically found that the broker had no knowledge of the registered representative's fraud but that its violation of the rule "without more", i.e., without attributing fraud to the broker, was actionable.

The latest commentary on the topic is in agreement that there is no basis for requiring fraud as an element of liability for violations of Exchange Rules. In an article by Edward Brodsky, an eminent securities attorney, entitled "Corporate and Securities Litigation" appearing on page 1 of the October 2, 1974 New York Law Journal, it is stated that there is no basis

for fraud to be a required element of liability and it is illogical to so hold, that the particular rule and its place in the regulatory scheme is determinative as to liability, that rules which are actionable are those designed to protect investors as distinguished from "housekeeping" rules, that the "know your customer" rule is so intertwined with Rule 10(b)-5 that an analysis of the legal issues involved with respect to the "know your customer" rule violation alone has been difficult to analyze from the past cases dealing therewith, that Starkman (supra) held that liability resulted from the nature of the rule rather than from any presence of fraud as required in McMaster Hutchison v. Rothschild & Co., CCH Fed. Sec. L. Rep. ¶93,541 (1972), and that the reasoning of the McMaster case was unsound.*

With respect to the issue as to whether fraud is required for liability, the article states:

> "It has been suggested that a Stock Exchange Rule violation is actionable when 'fraud' is alleged but not otherwise. McMaster Hutchison & Co. v. Rothschild & Co., supra. However, the Securities laws do not suggest that federal jurisdiction depends on whether or not fraud is alleged. Moreover, in most of the cases know your customer and Rule 10(b)-5 violations are combined, blending the legal issues and making a pure analysis of the Stock Exchange Rule violations difficult.
>
> "To the extent that a 'fraud' violation must be alleged before Exchange Rules are actionable then Stock Exchange and dealer association rules are meaningless vehicles for federal civil liability

*See pages 42-49 of appellants' main brief for a complete analyses of the erroneous reasoning in McMaster.

> because almost by definition the purchase or sale of securities will be involved and the claim, to the extent that it alleges fraud, will fall within the broad scope of Rule 10(b)-5. No court seems to have so explicitly held, yet one is hard put to think of facts that may state an Exchange Rule violation which will give rise to implied federal civil liability without at the same time stating a 10(b)-5 violation."

The article states a proper guide for determining whether Exchange Rules are actionable which is that set forth by appellants, to wit:

> "To the extent that the courts are saying that Stock Exchange Rules which may be the foundation for implied federal civil liability are those designed to protect investors, as distinguished from 'housekeeping' rules which are not actionable, one has some reasonably predictable guidelines for making distinctions."

A copy of Mr. Brodsky's article is annexed hereto, as an appendix, for the court's convenience.

REPLY POINT III

Any Factual Finding By The District Court That Boeing Did Comply With The Publicity Requirements of the Exchange Is Reversible By This Court As Clearly Erroneous.

Appellees contend that this District Court found, as a fact, that Boeing complied with the publicity requirements of the Exchange, and that this court is bound by any such factual finding. Firstly, it is doubtful that the District Court even intended its statement that Boeing complied with the rule to be factual, since such statement did not appear under the portion

of the District Court's opinion devoted to its findings, but under the portion where its legal conclusions were set forth. Assuming, arguendo, that the finding was factual, and not a conclusion of law, the finding is clearly erroneous, within the meaning of F.R.C.P. 36(b) and, thus, reversible by this court.

The court is respectfully referred to pages 24-28 of appellants' main brief, where it is shown that any such factual finding is clearly erroneous and, therefore, the matter contained on those pages will not be needlessly repeated here.

REPLY POINT IV

Appellees Have Failed To Show That Plaintiffs Are Not Third Party Beneficiaries Of The Listing Agreement.

Appellees argue that the Exchange's remedy for breach of the listing agreement is limited to de-listing and that, since a third party beneficiary to a contract has no broader rights or remedies than the parties thereto, the appellants cannot obtain damages for breach of the contract since the Exchange cannot. In support of their statement that the Exchange's remedies are limited to de-listing, appellees refer to the Report of Special Studies of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong. 1st Sess., Pt. 4, Ch. XII at 566 & 567, and to Intercontinental Industries, Inc. v. American Stock Exchange, 452 F. 2d 935 (5th Cir. 1971), cert. denied 409 U.S. 842 (1972) which show that the Exchange

may delist a company if it breaches the agreement. However, there is nothing in the authority cited by the appellees, or anywhere else, that says that the <u>exclusive</u> remedy of the Exchange is de-listing. Therefore, the Exchange's remedies are not limited to a de-listing and, thus, neither are the plaintiffs.

Appellees attempt to distinguish one of the cases cited by appellants in support of the third party beneficiary argument, <u>Weinburger</u> v. <u>New York Stock Exchange</u>, 335 F. Supp. 139, by citing footnote 10 of the court's opinion therein. The footnote states, "Since the Exchange is already liable for any breach of its statutory duty, the imposition of a virtually coterminous contractual duty will not have the disruptive effect of an unexpected civil liability, which is sometimes seen as an argument against third party recovery." Appellees then argue that, since there is no statutory liability of Boeing to the plaintiffs (assuming Point I of appellants' main brief is entirely discounted), there is no coterminous liability created by the contract and, thus, the instant action is distinguishable from <u>Weinburger</u>. However, the appellees are referring to a mere footnote and the court is, therefore, in no way stating that its decision or opinion is based upon the thought contained in the footnote. Moreover, if the argument described in the footnote were followed to its logical conclusion, it would have to be concluded that there <u>never</u> is any

third party contractual liability independent of other liability. Such a conclusion is clearly and obviously contrary to the overwhelming established case law, and it is obvious that nothing in the court's opinion was intended to reverse or contradict such case law. Clearly, the footnote was simply a tangential thought involving contracts expressly required by legislation, which was inserted only because such a contract was involved in that case. Moreover, even if it is assumed, arguendo, that the Weinburger case is distinguishable from the case at bar, the other cases cited by appellants are more than sufficient to support liability to them as third party beneficiaries.

The appellees argue that appellants cannot recover because they are bound by their first contract, namely the Indenture, and the listing agreement is inconsistent therewith. However, the obligations of Boeing under the listing agreement are not inconsistent with those under the indenture, but are additive thereto. Moreover, if there is any inconsistency between the Indenture and the Listing Agreement, the Listing Agreement, being the last of the two contracts entered into, would govern. It is an elementary law of contracts that, in the event of an inconsistency between the terms of two contracts, the terms of the latest contract govern. Corbin On Contracts, ¶1296 p. 1066-1067 (One Vol. Edition, 1952). The case of Constable v. National Steamships Co., 154 U.S. 51, cited by the

appellees, is completely inapplicable to the case at bar. In the Constable case, one party to the contract subsequently entered into an inconsistent contract without the consent of the other party. However, in the case at bar, there was no entering into a subsequent agreement by the appellants without Boeing's consent since Boeing was a party to both the Indenture Agreement and the Listing Agreement and, thus, necessarily consented to both.

Finally, the appellees argue that the plaintiffs cannot prevail on the third party beneficiary doctrine because there is no proof that Boeing's failure to issue the general news release caused their loss. However, the undisputed evidence necessarily and conclusively establishes that the breach caused the loss. The loss the plaintiffs suffered was the loss of their right to convert. This valuable right was wrongfully taken from the plaintiffs only because of the fact that Boeing cut off the conversion privileges in breach of the Listing Agreement. Thus, contrary to appellees' contentions, Boeing's actions directly and necessarily caused appellants' loss.

Although the evidence conclusively shows that Boeing's breach caused appellants' damage, such evidence is not required for the appellants to prevail. The U. S. Supreme Court has recognized that, in representative suits, it must be presumed that the breach or violation caused the damage to the class.

In Affiliated Ute Citizens v. United States, 30 L. Ed. 2d 128 (1972) the Supreme Court recognized that such a presumption is essential in representative actions and held that, in an action based upon a failure to disclose:

> "Positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important . .. [The] obligation to disclose and [the] withholding of a material fact established the requisite element of causation and fact."

In the face of the foregoing, Boeing has failed to show any evidence to exculpate itself from liability, or to show that its breach of the publicity provisions of the listing agreement did not cause the precise damage that such provisions were designed to prevent.

REPLY POINT V

The General Arguments Set Forth By Appellees Attempting To Show That The Indenture Was Not A Contract Of Adhesion Fail To Take Into Account The Specific Facts And Circumstances Of This Case.

The appelllees have cited a number of authorities wherein it was held that notice was sufficient and attempt to generalize therefrom to the instant action. However, since adequate notice required to preclude a contract of adhesion is the notice which is reasonably calculated to provide actual notice under the circumstances, the appellees authorities are not applicable here. As stated in Mullane v. Central Hanover

Bank & Trust Company, 339 U.S. 306 (1950), which was cited in Eisen v. Carlisle & Jacquelin, 42 L. W. 4804, "publication notice could not satisfy due process where the names and addresses of the beneficiaries were known."

Although appellees contend that trading of the debentures prevented them from knowing the names and addresses of all of the holders, a mailing to the names and addresses that were known would have reached a substantial portion and, thus, would have been notice more reasonably designed to reach all.

Boeing would not even have had to expend substantial additional sums to provide mail notice to the record debenture holders that the redemption was at least imminent. On February 28, 1966, only eight days before the publication of the first formalized notice of redemption on March 8, 1966, Boeing mailed a proxy statement and letter to its stockholder in connection with the shareholders' meeting to be held on April 25, 1966 (A 153(a) ¶37, E 37). However, nothing was said in the proxy statement or the letter to the effect that several meetings had already been held preparatory to the redemption, nor that on that very day a board meeting was being held to authorize the redemption. If Boeing had made a realistic effort to reach all of the debenture holders with notice of the redemption, it could have at least made some mention of the redemption in the proxy statement or in the letter at no additional cost.

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his particular case to notify the
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viate the hardship upon the holders
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tfully submitted,

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Corporate And Securities Litigation

By Edward Brodsky

This column is a regular feature of the LAW JOURNAL. *T... author is a member of the firm of Goldstein, Shames & Hy... a former Assistant U. S. Attorney and a former attorney ... the civil division of the Department of Justice.*

The 'Know-Your-Customer Rule' – (II)

The decided cases involving the 'know-your-customer' and other stock exchange and dealer association rules are not models of clarity. For example, pointed out in our last column (Sept. 4), a few years ago one court held that there is no implied federal civil liability for violation of any stock exchange rule.[1] Later, it was held that certain stock exchange rules may be actionable but the question could not be decided on the allegations of the complaint.[2]

A few months ago, in *Starkman v. Scroussi*, stock exchange rules were not only held actionable on the allegations of the complaint but were used to avoid an otherwise valid arbitration agreement between a brokerage firm and its customer.[3]

Practical Significance

The implication of federal civil liability for stock exchange rule violations has important practical significance. First, it gives the federal court exclusive jurisdiction in what ordinarily might be a state action.[4] Second, as most recently held in *Starkman*, it enables a customer of a brokerage firm to avoid an otherwise enforcible arbit... agreement.[5] Thus, it is w... analyze the divergent ... ments which have led at ... to opposite conclusions.

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In view of Boeing's failure to utilize any of the means available to it in this particular case to notify the debenture holders of the redemption, but its reliance only upon meeting the formal publication requirement of the Indenture together with other formal publications of notice, Boeing did nothing to alleviate the hardship upon the holders created by the provisions of the contract of adhesion, i.e., the Indenture.

Respectfully submitted,

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ADDENDUM

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By Edward Brodsky

This column is a regular feature of the LAW JOURNAL. *The author is a member of the firm of Goldstein, Shames & Hyde, a former Assistant U. S. Attorney and a former attorney in the civil division of the Department of Justice.*

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What is the theory underlying implied federal civil liability for the violation of stock exchange rules? What are the arguments which have been advanced in favor of and against the implication of liability? Since it has been held that not all stock exchange rules are actionable, how does one predict in a case of first impression whether or not a particular rule will be actionable?

In *Starkman v. Scroussi*, which appears to be the most recent case on the subject, Judge Weinfeld, in the District Court for the Southern District of New York, was faced with a claim by a customer that a brokerage firm and its registered representative had violated stock exchange rules (1) that prohibit registered representatives from sharing profits and losses with customers;[6] (2) that require brokerage firms to investigate their registered representatives thoroughly before hiring them—the claim being that if such investigation had been made the firm would have discovered that the brokerage firm that had previously employed the registered representative had discharged him for cause;[7] and (3) that require the firm not to purchase securities on behalf of a customer which are unsuitable for his account — the know-your-customer rule.[8]

The issue was whether the claimed stock exchange rule violations justified the avoidance of an arbitration agreement, just as claimed violations of the securities laws or regulations are the basis for avoiding arbitration.[9] The court analyzed the problem as follows:

The Securities Act of 1934 provides that no securities exchange may be registered with the SEC unless it adopts rules which are adequate to insure fair dealing and to protect investors.[10] The stock exchange rules that the defendants were charged with violating were adopted by the exchange as a prerequisite to its registration with the SEC.

The 1934 Act provides exclusive jurisdiction in the Federal District Courts for (i) violations of the Act and (ii) the rules and regulations promulgated thereunder, and (iii) actions brought to enforce "any liability or duty created by this chapter or the rules and regulations thereunder. . . ."[11] Stock exchange rules are not violations of the 1934 Act or the rules and regulations promulgated thereunder. Thus, the narrow question, according to the court in *Starkman*,[12] was whether "a violation by a member of the Exchange of its rules, filed pursuant to the statute, may be actionable as a violation of a 'duty created by this chapter.'"

The court answered the question by reference to the following standard of liability suggested by Judge Friendly in *Colonial Realty Corp. v. Bache & Co.*:

"Whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of a statute or a SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law."[13]

Burden Carried

After quoting that language from *Colonial*, Judge Weinfeld, referring to the particular rules the defendants were accused of violating, said that ". . . upon the facts here presented" plaintiff sufficiently carried his burden to establish jurisdiction under Section 27 of the Exchange Act."[14] The court said that rules the defendants were charged with violating were precise and have among their purposes protection of the customer. They may be considered an integral part of SEC regulations in furtherance of the purpose of the 1934 Act to "insure fair dealing and to protect investors."[15]

For those reasons and using the standard of *Colonial*, the court, in effect, found that if the facts in the complaint were true there would be a violation of stock exchange rules, implied

Addendum

federal civil liability for the violation and therefore the brokerage firm was not entitled to arbitrate its claim despite an otherwise valid arbitration agreement.

While Judge Weinfeld in *Starkman* concluded that a violation of stock exchange rules would, under the circumstances of that case, result in federal civil liability, the opposite result also has been reached — at least where no fraud was alleged.

In a previous case [16] the plaintiff unsuccessfully urged the court to hold that the know-your-customer rule created a federally protected right as follows:

Purpose of Rules

Under the Securities Exchange Act of 1934 national securities exchanges are registered with the SEC. Their rules must be "designed to prevent fraudulent and manipulative acts . . ." and "protect investors and the public interest. . . ." [17]

Although "the SEC has delegated to the securities exchanges rule-making authority over the activities of their members, the SEC itself maintains control over nonmember brokers and dealers. . . ." [18] There is a "parallel" SEC rule for nonmember firms and "because both rules have the same source of authority, the 1934 Act, it would be manifestly unjust to draw the distinction that one of the rules (15b-10-4) presents the basis for a federally recognizable issue while the other [the know-your-customer rule] does not simply because the former was promulgated by the SEC while the latter was promulgated by an individual exchange acting under the specific delegated authority of the SEC." [19]

The court, however, dismissed the complaint, concluding that "the distinction must be drawn" [20] by the following analysis:

'Obvious Manner'

When Congress intended to refer to exchange rules it did so "in a very obvious manner" [21] such as in that portion of the 1934 Act which provides that any attempted waiver of any provision of the act or any "rule of an exchange" is void.[22] Moreover, the 1934 Act provides it shall be construed to prevent an exchange from adopting any rule not inconsistent with applicable state law; if the know-your-customer rule were "the equivalent of federal law . . ." stock exchange rules would take precedence over state law.[23]

The court also referred to "strong policy reasons for finding that rules of stock exchanges do not set forth federally protected rights" particularly referring to *Colonial Realty Corp. v. Bache & Co.*,[24] in which the Court of Appeals for the Second Circuit expressed concern that federal courts might be saddled with "garden-variety customer-broker suits, even though the controversy was between citizens of the same state, the sum in question did not attain the jurisdictional amount required by 28 U. S. C., section 1331, and there was no indication that the case would be decided differently under state law. . . ." [25]

Despite the above analysis, the trend of the cases seems to be towards holding that certain exchange rules are actionable— at least under some circumstances. However, the standards for proving violations are unclear and blurred by a combination of the exchange rule violations with "fraud" violations, such as Rule 10b-5.

Predictable Guidelines

To the extent that the courts are saying that stock exchange rules which may be the foundation for implied federal civil liability are those designed to protect investors, as distinguished from "housekeeping" rules which are not actionable,[26] one has some reasonably predictable guidelines for making distinctions. However, it is difficult to tell what the court in *Colonial Realty* means, in terms of practical application, when it says that a party arguing the implication of federal liability has a "considerably heavier burden of persuasion" when it urges a breach of an exchange rule and that "[t]he case for implication would be strongest when the rule imposes an explicit duty unknown to the common law. . . ." [27] Phrasing the question in terms of burden of persuasion on a scale of whether or not the duty was known to the common law has no apparent foundation in the securities laws.

A 202 Affidavit of Personal Service of Papers LUTZ APPELLATE PRINTERS INC.

US COURT OF APPEALS: SECOND CIRCUIT

Index No.

VAN GERMERT, et al

Plaintiff-Appellants.

against

Affidavit of Personal Service

BOEING, et al,

Defendants-Appellees.

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

I, James Steele, *being duly sworn, deposes and says that deponent is not a party to the action, is over 18 years of age and resides at* 250 West 146th Street, New York, New York

That on the 14th *day of* November *19*74 *at* *

deponent served the annexed Brief *upon*

*

the *in this action by delivering a true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the* Attorney(s) *herein,*

Sworn to before me, this 14th *day of* November *19*74

Robert T. Brin

James Steele

Print name beneath signature

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COMMISSION EXPIRES MARCH 30, 1975